The Challenge of Valuation Guidelines

Introduction

Industry participants are adopting the valuation guidelines developed by the Private Equity Industry Guidelines Group (PEIGG) more broadly in the US than previously thought, according to an online survey of general partners recently conducted by The Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth. Nearly 20% of the 102 respondents indicated they had formally adopted the PEIGG guidelines, while several more indicated that PEIGG had influenced their internal valuation policies.

The Center hosted a by-invitation conference in June to bring together GPs, LPs, accountants, advisors, and representatives of numerous US and international industry associations to discuss the issues surrounding valuation policies. Both the survey data and comments by participants at the conference indicate that there is still a strong discomfort among GPs to Paragraph 30 of PEIGG, which allows non-round write-ups. Respondents and participants also expressed skepticism about global convergence of valuation guidelines.

More importantly, the survey and the comments by conference participants suggest that role and influence of independent auditors is growing. There will continue to be tensions among LPs’ desire for consistency, GPs’ historical preference for privacy, and auditors’ obligation to apply fair value principles that are not formulaic. As the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) further develop their principles-based guidelines, auditors may ultimately be the force that determines the outcome for the application of valuation guidelines in the US and also drives global convergence.

Perspectives on U.S. and International Guidelines

Respondents to the Tuck survey represented a broad cross section of GPs with diversity in investment style, fund size, and number of funds under management. Of the 102 respondents, nearly 70% were VCs and 25% were buyout funds. About 50% of respondents said they relied on well-known industry guidelines for their internal valuation policies, indicating a general acceptance of guidelines as a useful tool to drive internal policies. The 2005 survey followed up on a similar survey by the Center in 2003 and showed that, despite consistent industry attitudes over time about support for valuation guidelines (from about 50% of GPs) as well as opposition (from nearly 20% of GPs), the influence of PEIGG had taken hold.

The PEIGG valuation guidelines, developed 18 months ago (see www.peigg.org), have been endorsed by the Institutional Limited Partners Association (ILPA), which represents over 125 LPs. The Tuck survey and comments made at the conference indicate that comprehensive adoption will take time, if it happens at all. About half of GP survey respondents that specifically had not adopted PEIGG indicated that they preferred write-ups only after a new round of financing. The National Venture Capital Association (NVCA), which represents VCs but not buyout firms, chose not to endorse PEIGG, although it commended the group’s efforts. In a 2004 press release the NVCA announced that it “encourages diligence, prudence, and caution when implementing the specific elements of any guideline, such as valuation write-ups of early-stage companies in the absence of market-based financing events.”

Despite the situation in the U.S., the rest of the private equity world is

continued on page 12
The Challenge of Valuation Guidelines (cont. from page 11)

making meaningful progress toward commonly accepted guidelines. Recently, three European industry associations, the Association Française des Investisseurs en Capital (AFIC), the European Venture Capital Association (EVCA), and the British Venture Capital Association (BVCA), issued joint valuation guidelines that were rapidly adopted by over 25 countries and endorsed by ILPA.

The PEIGG board represented a broad cross-section of U.S. industry participants. This broad-based effort served to encourage the European associations to work more collaboratively. The international guidelines are based on fair value principles and aim to be consistent with both U.S. generally accepted accounting principles (GAAP), as well as IASB principles. Nevertheless, as the Tuck survey of U.S. GPs indicated, convergence of standards may be difficult to achieve. One quarter of respondents believe convergence of valuation guidelines will occur within 3 to 5 years. Another third of respondents believe convergence will take 5 to 10 years, and nearly 40% say it will never happen.

The Tuck survey also indicated significant reluctance by U.S. GPs to fully apply fair value accounting principles. This was clear in the substantial reported impact on portfolio valuations, if GPs were to mark to market, as shown in Figure 1, page 11. Pressure to aggressively mark to market is not present. LPs are generally seen by GPs as not giving this a high priority, and auditors, while more active, are not insisting on changes (see Figure 2). Conference discussions showed that this situation might be substantially inconsistent with what accounting authorities are intending for fair value principles.

Key Issues

Is there a contradiction?

Nearly 80% of survey respondents believe that their current policies adequately reflect fair value. Yet, the survey results showed that many of the same respondents believe the application of fair value could lead to material write-ups. Accountants seem to indicate this means current financial statements of many private equity firms may not be fully GAAP compliant. An overwhelming majority of respondents (75%) said they would change their valuation policy in order to secure an unqualified opinion. However, 60% of GPs report that they believe LPs would be willing to overlook qualified audit opinions as long as fund performance is satisfactory. In addition, 25% of GPs provide their investors with “side schedules” that contain up-to-date valuation estimates that differ from audited financial statements. Ninety-eight percent of survey respondents said their auditors did not issue a qualified opinion to them for fiscal year 2004.

Is this only important to VCs?

Interim valuations are more of a challenge for VCs, since buyout funds can rely on operating cash flows as a basis for valuation. While European VCs and buyout funds have broadly agreed on guidelines, this agreement may reflect the relatively small portion of capital that venture capital represents within the entire European private equity industry. Some LPs have expressed concern over “stale” valuations that do not reflect economic reality and cite examples of pre-IPO portfolio companies like Google carried “at cost.” Some GPs argue that a conservative philosophy of under-promising and over-delivering is better for all parties. Other GPs say that continually adjusting interim evaluations of early and mid-stage growth companies serves no purpose.

Times are good for many private equity practitioners so pressure to do something about valuation guidelines is not likely to come from the industry. Instead, it is likely come from the accounting standard setters’ and auditors’ increasing insistence on fair value.

Figure 2: Auditors not insistent on changes

“If your valuation policy does not allow for non-financing round write-ups, does your independent auditor accept this without qualification as GAAP “fair value?”

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venture</td>
<td>80%</td>
<td>20%</td>
</tr>
<tr>
<td>Buyout</td>
<td>50%</td>
<td>50%</td>
</tr>
</tbody>
</table>
associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal."

The EITF's decision that super-majority without-cause kick-out rights will not override the presumption of general partner control is probably the most significant change in accounting practice for the consolidation of a Fund general partner with the Fund. As noted above, most Fund GP's have relied on supermajority kick-out rights to avoid consolidation under current practice.

Many general partners are wholly unwilling to provide a without-cause kick-out right to limited partners holding a bare majority of their Fund's LP interests. Others may be willing to do so only if limitations are imposed on the right or if there are significant disincentives to the limited partners' exercising the right. Because such limitations and disincentives may make the kick-out right non-substantive — and thus not overcome the presumption of GP control — Fund general partners will need to work closely with their accounting and legal advisers on the establishment or amendment of kick-out rights.

In the final analysis, it may be easiest simply to provide a bare majority kick-out right without significant limitations — and then for the Fund sponsor to make even greater efforts to maintain the goodwill of its limited partner investors.

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1 The supermajority has generally been a 66-2/3% majority in interest of the limited partners. 75% and even 80% supermajority GP removal provisions have also been seen in practice.

2 U.S. GAAP requires an entity that “controls” another entity to include all of the controlled entity's assets, liabilities, revenues and expenses in the controlling entity's own consolidated financial statements. For consideration purposes, “control” is generally defined as ownership of a majority (more than 50%) of the outstanding voting equity interests of an entity.

3 Most non-institutional sponsors prepare GAAP financials for their Funds, but not for themselves, since the sponsors and Fund general partners are generally privately held by firms or individuals that do not themselves require GAAP financials.

4 Including other types of entities having governance provisions that are similar to those of limited partnerships, such as limited liability companies where only the managing members have the power to manage the affairs of the LLC.

The Challenge of Valuation Guidelines (cont. from page 12)

Do LPs want judgment calls or do they want consistency?
If interim valuations depend heavily on VC judgment and the application of multiple methodologies, it can be expected that different VCs will produce different valuation figures. Will LPs continue to be comfortable with this? The proposed 1989 NVCA guidelines, commonly used by the industry in previous years, had always been clear about requiring write-downs. However, LPs’ anxiety over the lack of discipline by GPs in the timing and amount of post-bubble write-downs are exactly what led to pressure for developing new guidelines. Yet non-round write-ups, as allowed by PEIGG, may result in inconsistencies of valuation and timing in an era of economic growth.

Conclusion
Times are good for many private equity practitioners so pressure to do something about valuation guidelines is not likely to come from the industry. Instead, it is likely come from the accounting standard-setters’ and auditors’ increasing insistence on fair value. “Conservatism” is a dirty word to accountants - it refers to a willful and artificially low valuation of an asset. The result of the accounting industry’s drive for fair value will be a tension between judgment and consistency in valuing portfolio companies. Industry guidelines or even new accounting regulations are unlikely to eliminate this tension, because they deal with statements of principle. Valuation guidelines cannot be formulaic and at the same time be effective because such prescriptive guidelines will invariably fail to include all situations or become too complicated to be useful. The judgment / consistency issue in private equity can only be resolved in the U.S. and internationally through years of application and incremental learning. In the interim there will continue to be grappling and discomfort before broad agreement on best practices emerges.

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